Office of Chief Counsel
Internal Revenue Service

memorandum

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JJBoyle

date: MAR 25 2002

to: Appeals Officer [redacted], Louisville

from: Associate Area Counsel (LMSB/2), Cincinnati

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subject: [redacted] Inc.

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This memorandum is submitted in response to Appeals Officer [redacted]'s request for our assistance concerning the proposed disallowance of a $[redacted] interest deduction that the taxpayer claimed on an amended return filed for its taxable year ended [redacted] (FYE [redacted]).

ISSUE

Whether $[redacted] in contingent payments that the taxpayer made pursuant to four "fee letters" are deductible as interest under I.R.C. § 163(a).

CONCLUSION

For the reasons set forth herein, it is our opinion that the contingent payments are not deductible as interest.

FACTS

[redacted] Inc. and Subsidiaries (the taxpayer or [redacted] Holdings) was formed in [redacted] to acquire from [redacted] the North American distribution rights to [redacted]. The acquisition was financed through a subsidiary of the taxpayer, [redacted] Company, Inc. [redacted], using a combination of senior and mezzanine borrowings, along with equity contributed by the shareholders. The senior debt in the amount of $[redacted] was financed through a Credit Agreement with [redacted], which was

[redacted]. The mezzanine debt (defined as subordinate to the senior debt but superior to all unsecured debt) was a $[redacted] Note with a group of investment partnerships, which subsequently sold the Note to three other entities--[redacted] Partners, [redacted] Fund, and [redacted] Company.

On [redacted], the taxpayer made the following payments (contingent payments) totaling $[redacted]:

Payee	Amount
[redacted] Partners	$[redacted]
[redacted] Fund	
[redacted] Company	

On an amended return that it filed for FYE [redacted], the taxpayer treated the contingent payments as a $[redacted] interest deduction. The Examination Division proposes to disallow the entire $[redacted] deduction on grounds that the contingent payments are not deductible as interest. The facts relating to the contingent payments are separately discussed below:

1. **The Transactions Related to the $[redacted] payment to [redacted]**

A. The [redacted] Transactions

In [redacted], [redacted] entered into a Credit Agreement with various banks and financial institutions (lenders) and [redacted], as agent (the [redacted] Credit Agreement) for a $[redacted] credit line through [redacted]. The [redacted] Credit Agreement was dated as of [redacted].

The [redacted] Credit Agreement contained extensive provisions regarding repayment and interest. It provided for the payment to [redacted] of term advances and working capital advances. [redacted] was required to repay the term advances in quarterly installments to [redacted] for the ratable account of the term lenders, from [redacted] through [redacted]. [redacted] was required to repay the working capital advances to [redacted] for the ratable account of the

working capital lenders on [redacted].[1] The [redacted] Credit Agreement provided for [redacted]'s payment of interest on the unpaid principal amount of each advance. The interest was payable at either a Base Rate or a Eurodollar Rate depending on the characterization of the advance as a Base Rate Advance or a Eurodollar Rate Advance.[2]

The [redacted] Credit Agreement also provided for the payment of: (1) default interest at a rate equal to [redacted] percent of the interest due on any late payment; (2) a commitment fee to the agent for the account of the lenders; and (3) an agent's fees "as from time to time may be agreed upon between the borrower [redacted] and the Agent [redacted]." The [redacted] Credit Agreement further required its amendment or the waiver of any provision to be in writing and signed by "required lenders."[3]

On [redacted], the taxpayer and [redacted] issued [redacted] a "fee letter" ([redacted] fee letter), which made reference to "the Credit Agreement dated as of [redacted]." The [redacted] fee letter provided for the payment to [redacted] of a "Success Participation Fee" in an amount equal to a certain "Agreed Value" upon the occurrence of a "Capital Valuation Event." The Agreed Value was defined as an amount equal to EBITDA for a fiscal year, and was payable in semiannual installments over [redacted] years. A "Capital Valuation Event" was defined as the earlier of [redacted] or

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[1] The [redacted] Credit Agreement includes as parties to the agreement "the banks and financial institutions ... listed on the signature pages hereof." However, the only bank or other lending institution listed on the signature page or anywhere else in the agreement or its attachments is the [redacted].

[2] The Base Rate was the higher of the rate of interest designated by [redacted] in [redacted], [redacted] as its prime rate and [redacted] of [redacted]% per annum above the Federal Funds Rate. The Eurodollar Rate was calculated based on the rate which deposits in U.S. dollars were offered by the principal office of [redacted] in [redacted] to prime banks in [redacted] and the percentage of the Eurodollar Rate Reserve.

[3] The term "required lenders" was defined as "[redacted]."

the date that advances received under the [redacted] Credit Agreement company repaid or prepaid (other than as a result of refinancing).

The [redacted] fee letter further provided, inter alia, that: (1) the obligation therein was subordinated to the prior payment of certain senior obligations; (2) no payment was required to be made in any fiscal year in which EBITDA fell below a stated level; (3) [redacted] could repurchase [redacted]'s rights under the fee letter after the second anniversary of the Capital Valuation Event; and (4) [redacted], "by acceptance of this letter, represents ... that [it] is entering into this letter for the purpose of investment and not with a view to a distribution hereof."[4]

B. The [redacted] Transactions

On [redacted], [redacted] replaced the [redacted] Credit Agreement with a credit agreement through [redacted] (the [redacted] Credit Agreement) for a $[redacted] credit line through [redacted]. As set forth therein, the proceeds from the [redacted] Credit Agreement were to be used to: (1) refinance the [redacted] Credit Agreement; (2) finance a [redacted] Equity Repurchase; (3) pay transaction fees and expenses; and (4) provide working capital. The [redacted] Credit Agreement provided for [redacted]'s repayment of advances to the lenders in quarterly installments of $[redacted] by [redacted] with interest at a LIBOR rate. In [redacted], proceeds from the [redacted] Credit Agreement were used to pay off all advances and stated interest due under the [redacted] Credit Agreement.[5]

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[4] Curiously, there was no reference in the [redacted] Credit Agreement to a "fee letter" or any contingent obligation. Moreover, despite the requirement that any amendment thereto be in writing signed by a required lender, our copy of the "[redacted] fee letter" is unsigned by [redacted], the only lender. Nor is there anything evidencing [redacted]'s contemporaneous acceptance of the fee letter's terms, although certainly the [redacted] fee letter is signed by "the parties to be charged."

[5] According to the taxpayer, "[i]n [redacted] except for the contingency portion, the [redacted] Loan was refinanced with [redacted]" It is our understanding that because the taxpayer charactered the [redacted] Credit Agreement's payoff as refinancing no payment was required under the [redacted] fee letter. However, the term "refinancing" is not defined in either the [redacted] Credit Agreement or the [redacted] fee letter.

C. The Transactions

In , sent a letter advising that:

> Pursuant to a Stock Purchase Agreement dated as of between Holdings Company, Ltd. (") and Holdings, L.L.C. (""), has agreed to sell all of the shares of capital stock of Holdings to and pursuant to such transactions all indebtedness for borrowed money of will be repaid in full, and, therefore, such transactions if consummated will constitute a Capital Valuation Event.

In the letter, also proposed to pay an Agreed Value of $ in a lump sum amount. agreed to both the amount and the manner of the payment.

It is our understanding that such payment was made to by on or before . As indicated, the taxpayer claimed the $ payment to as part of a $ interest deduction that it is claiming for FYE .

2. The Transactions Related to the $ Payments to Partners and Company and the $ Payment to Fund.

A. The Transactions

On , also entered into a Note Purchase Agreement (Note) with four investment partnerships managed by Management Company ( ) in exchange for $. The Note had a fixed interest rate of percent, payable in semiannual installments beginning on . Repayment of the $ principal amount was to occur in a single installment on . In addition to the Note, acquired shares of the taxpayer's voting common stock for $.

B. The Transactions

subsequently ran into cash flow problems. On , sold the Note in accordance with a Subordinated Note Purchase Agreement for $ to three purchasers (collectively referred to as the holders): (1) Partners, L.P. (Partners); (2) Company ( ); and (3)

[redacted] L.P. ([redacted] Fund). On that same date, the taxpayer redeemed the [redacted] shares of its [redacted] voting common stock from [redacted] for $[redacted].

On [redacted], the holders and [redacted] entered into Amendment No. 1 to Note Purchase Agreement (the Amendment), which, inter alia, changed the Note's maturity date from [redacted] to [redacted]. On that same date, each holder and [redacted] entered into a Senior Subordinated Note Due [redacted] (Senior Subordinated Note), in an amount equal to their respective pro rata shares of the $[redacted] principal. [redacted] Partners and [redacted] shares were $[redacted] and [redacted] Fund's share was $[redacted].

The Senior Subordinated Notes contained specific provisions regarding repayment and interest. Each Senior Subordinated Note provided for repayment of the $[redacted] principal amount in a single installment on [redacted] and the payment interest in semiannual installments beginning on [redacted] For the first year, interest on the unpaid principal was to be computed at a LIBOR rate plus [redacted] percent. Thereafter, interest was payable at the LIBOR plus [redacted] percent rate or at a fixed rate of [redacted] percent rate, at [redacted]'s election. Each of the Senior Subordinated Notes also provided for the payment of default interest equal to [redacted] percent over the interest rate in effect.[6]

On [redacted], the taxpayer and [redacted] issued separate "fee letters," (holders' fee letters) to [redacted], [redacted] Partners, and [redacted] Fund. The first sentence of each fee letter made reference to "the Note Purchase Agreement of [redacted] as amended by Amendment No. 1." Each fee letter required [redacted] to pay the respective holder an "Agreed Value" in four installments over [redacted] fiscal years from a specified "Determination Date." The Agreed Value was based on EBITDA for one fiscal year prior to the "Determination Date." The Determination Date was defined as the earlier of: (1) [redacted]; (2) repayment of the Note by the taxpayer; or (3) a sale.[7]

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[6] In [redacted], the six-month LIBOR rate stood at [redacted] percent. From the taxpayer's protest, it appears that in the subsequent years the holders received interest at the [redacted] percent fixed rate.

[7] Neither the Amendment nor the Senior Subordinated Notes, contain any reference to a "fee letter" or contingent obligation. There is also nothing evidencing any holder's contemporaneous acceptance of the fee letter terms, but again the fee letters are signed by "the parties to be charged."

Each fee letter further provided, inter alia, that: (1) the obligations evidenced in the fee letter were subordinated to the prior payment in full of certain senior obligations; (2) [redacted] could, at its option, defer payment of the portion of any installment for which there was insufficient "Free Cash" after notification of the payee; (3) the unpaid portion of any installment payment was subject to interest and deemed to be a general unsecured obligation of [redacted] and (4) each holder, "by acceptance of this letter, represents ... that [it] is entering into this letter for the purpose of investment and not with a view to a distribution hereof."

C. The [redacted] Transactions

On [redacted], [redacted] sent each holder a letter advising that:

> Pursuant to a Stock Purchase Agreement dated as of [redacted] between [redacted] Holdings Company, Ltd. ("[redacted]") and [redacted] Holdings, L.L.C. ("[redacted]"), [redacted] has agreed to sell all of the shares of capital stock of Holdings to [redacted] and pursuant to such transactions all indebtedness for borrowed money of [redacted] will be repaid in full, and, therefore, such transactions if consummated will constitute a Sale.

In the letters, [redacted] proposed to pay each holder an Agreed Value in a lump sum amount as follows:

Holder	Amount
[redacted] Partners	$[redacted]
[redacted]	[redacted]
[redacted] Fund	[redacted]

Each holder agreed to both the amount and the manner of the payment. It is our understanding that [redacted] made the above payments, totaling $[redacted], to each holder on [redacted]. The taxpayer subsequently deducted these payments as part of the $[redacted] interest deduction claimed on its amended return for FYE [redacted].

3. The Parties' Positions

The Examination Division proposes to disallow the $[redacted] interest deduction on two grounds: (1) the contingent payments are not deductible as interest; and (2) the fee letters were separate and distinct agreements that did not qualify as debt instruments.

In its protest to the Examination Division's proposed disallowance, the taxpayer takes the position that the fee letters represented contingent debt obligations due under the senior and mezzanine debt agreements based on the factors set forth in I.R.C. § 385 and traditionally employed by the courts to distinguish debt from equity. According to the taxpayer, the debt agreements and the fee letters were legally interdependent as evidenced by: (1) unambiguous references to the debt instruments in the fee letters and (2) the fact that the "[redacted] loan agreement called for a contingent payment based upon a formula which was calculated on a multiple of EBITDA less debt and other obligations." Finally, the taxpayer defends the deductibility of the payments as interest on grounds that neither the contingent nature of the payment amount; the failure to call the payments interest; nor the future payment date precluded treatment of the payments as interest.

DISCUSSION

A taxpayer has no absolute right to deductions because they are a matter of legislative grace. New Colonial Inc. Co. v. Helvering, 292 U.S. 435, 440 (1934). Thus, in order to be entitled to any claimed deduction, the taxpayer must prove that they fit within the relevant statutory authorization. Welch v. Helvering, 290 U.S. 111, 115 (1933).

I.R.C. § 163(a) allows a taxpayer to deduct "all interest paid or accrued within a taxable year on indebtedness." Interest is compensation paid for the use or forbearance of money. Deputy v. Du Pont, 308 U.S. 488, 498 (1940). Section 163(a) generally dictates that four requirements be satisfied: (1) there is a genuine indebtedness; (2) the indebtedness is that of the taxpayer; (3) the payment is of "interest;" and (4) for cash method taxpayers, the interest is paid in the taxable year that the deduction is claimed. Midkiff v. Commissioner, 96 T.C. 724, 734 (1991), aff'd sub nom. Noguchi v. Commissioner, 992 F.2d 226 (9th Cir. 1993).

An "indebtedness" is an existing, unconditional, and legally enforceable obligation for the payment of a principal sum. Williams v. Commissioner, 47 T.C. 689, 692 (1967), aff'd, 409

F.2d 1361 (6th Cir. 1968), cert. denied, 394 U.S. 997 (1967); Midkiff v. Commissioner, 96 T.C. at 735. Although an indebtedness is an obligation, an obligation is not necessarily an "indebtedness" within the meaning of section 163(a). Deputy v. Du Pont, 308 U.S. at 497. To be interest on indebtedness, a payment must be made pursuant to an agreement providing either for the use of money by the payor or for the forbearance of enforcement of a money obligation of the payor. Smith v. Commissioner, 84 T.C. 889, 897 (1985), aff'd without published opinion, 805 F.2d 1073 (D.C. Cir. 1986). An obligation that is contingent is not an indebtedness with respect to which interest paid or accrued may be deducted. Burlington-Rock Island R.R., Co. v. United States, 321 F.2d 817 (5th Cir. 1963), cert. denied, 377 U.S. 943 (1964). Moreover, only interest accruing when the taxpayer is primarily liable on a debt is treated as "interest on indebtedness." Arrigoni v. Commissioner, 73 T.C. 792, 806 (1980).

On the other hand, to be deductible, there is no requirement that interest be reasonable or computed at a stated rate, so long as the amount is an ascertainable sum contracted for the use of borrowed money. See Dorzback v. Collison, 195 F.2d 69 (3d Cir. 1952). Thus, the possibility that no interest might be payable does not affect the character of the interest when actually paid. Kena, Inc. v. Commissioner, 44 B.T.A. 217, 221 (1941). Nor do labels given to a payment or transaction control its treatment as interest. Ultimately, however, it is the parties' intent, as evidenced by facts and circumstances surrounding the payment or transaction, that is relevant in determining whether an amount is to be treated as interest. See Halle v. Commissioner, 96-1 USTC ¶ 50,250 (4th Cir. 1996); Dunlap v. Commissioner, 74 T.C. 1377, 1421 (1980), rev'd on other grounds, 670 F.2d 785 (8th Cir. 1982); Kaempfer v. Commissioner, T.C. Memo. 1992-19.

It is undisputed here that: (1) the $[redacted] was paid in FYE [redacted]; (2) the contingent nature of the payments does not preclude their deductibility as interest since their amount was susceptible of computation and it appears that their payment was not so speculative as to create a contingent liability; (3) the [redacted] Credit Agreement and the Senior Subordinated Notes (collectively referred to as "the Debt Agreements") constitute an indebtedness of the taxpayer upon which interest accrued; and (4) fixed and floating rate interest payable thereunder should be deductible under section 163(a). Nevertheless, for the reasons set forth below, we do not believe that the contingent payments are deductible as interest under section 163(a).

Contrary to the taxpayer's claim, there is no interdependency among the agreements and the fee letters to

support the taxpayer's claim that the contingent payments should be treated as interest. First, other than general references to "the Note Purchase Agreement of [redacted] as amended by Amendment No. 1" in the first sentence in each holders' fee letter, there is nothing to suggest that any payment made in accordance therewith was intended to be contingent or additional interest. The [redacted] fee letter does not contain even that minimal reference. While it references a Credit Agreement dated as of [redacted]," the [redacted] Credit Agreement was dated as of [redacted]. Likewise, there is nothing in the [redacted] fee letter to suggest that any payment made in accordance therewith was intended to be contingent or additional interest. Finally, and most significantly, there is no reference whatsoever to the "fee letters" or any contingent obligation, interest or otherwise, in either the [redacted] Credit Agreement, the Note Purchase Agreement, Amendment No. 1 to the Note Purchase Agreement, the Subordinated Note Purchase Agreement, the Senior Subordinated Notes or any other document that we have been provided.

In our view, the four "fee letters," either standing alone or in conjunction with the Debt Agreements, do not support treatment of the contingent payments as interest. At bottom, there is no evidence suggesting that the contingent payments were compensation for the use or forbearance of money. Similarly, none of the fee letters evidence a legally enforceable obligation to pay a principal sum, and, accordingly, there is no "indebtedness" to support an interest deduction.[8]

It is also well settled that the payment or accrual of interest for tax purposes must be incidental to an unconditional and legally enforceable obligation of the taxpayer claiming the deduction. Autenreith v. Commissioner, 115 F.2d 856 (3d Cir. 1940). Thus, even assuming, arguendo, that the contingent payment to [redacted] could be treated as interest, the $[redacted] payment to [redacted] would still not be deductible. As the taxpayer readily concedes, all principal and interest specified under the [redacted] Credit Agreement were satisfied in [redacted] from proceeds of the [redacted] Credit Agreement. However, the $[redacted] contingent payment to [redacted] was not made until [redacted], at which time there was no indebtedness under the [redacted] Credit Agreement

[8] In any event, it appears that the [redacted] fee letter would not be a legally enforceable obligation with respect to the [redacted] Credit Agreement. The [redacted] Credit Agreement required any amendment to be in writing and signed by the "required lenders." The [redacted] fee letter is not signed by [redacted] or any other required lender.

for which the taxpayer was liable and upon which interest could accrue. In such absence of a valid indebtedness, even sums paid as "interest" are not deductible.

A review of other facts and circumstances further belies treatment of the contingent payments as interest.

Both the [redacted] Credit Agreement and the Senior Subordinated Notes specifically provide for the payment of stated interest at a fixed rate of [redacted] percent or a floating rate based on LIBOR plus a specified percentage, which the taxpayer acknowledges to be commercially acceptable. The specific provision for such specified and commercially acceptable interest in the [redacted] Credit Agreement and the Senior Subordinated Notes, absent the reference in either to any contingent interest obligation, undercuts the taxpayer's claim that the payments at issue should be treated as interest. Nor was there any reason for the taxpayer to pay a premium. As stated in its protest:

> Taxpayer could have borrowed funds from other lenders. There was no shortage of potential lending parties nor any inability to access capital markets.

Aside from the fact that the [redacted] Credit Agreement and the Senior Subordinated Notes do not reflect any contingent interest obligation, neither the fee letters themselves nor any correspondence relating thereto refer to any payments thereunder as interest, contingent or otherwise. Indeed, the taxpayer's use of the term "fee" to characterize the letters and the specific description of the payment to [redacted] as a "success participation fee," coupled with the total absence of the term "interest" anywhere in any of the fee letters suggests that the payments were not intended to be interest. Perhaps more telling than what the fee letters fail to say, however, is the statement in each fee letter to the effect that the holder was entering into the letter for the purpose of investment. This statement further reinforces the conclusion that the contingent payments were not intended to be interest.[9]

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[9] The facts that we have been presented adequately support the disallowance of the interest deduction under section 163(a). Nevertheless, to the extent that it would become necessary, we believe that an argument could be made that the contingent payments are equity based on the characterization of the payments as a "Success Participation Fee" in the [redacted] fee letter, together with the admission in each fee letter that the holder entered into the letter for the purpose of investment.

Please contact the undersigned at (513) 263-4856 if you have any questions or concerns regarding this memorandum.

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